PROPOSED FASB STAFF POSITION

No. FIN 46-d

Title: Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

Comment Deadline: October 10, 2003

Q—How do fees described in paragraphs 8(c) and 8(d) of Interpretation 46 that are paid by a variable interest entity affect the calculation of *expected losses* and *expected residual returns* of a variable interest entity?

Background

Paragraph 8 lists four components of *expected losses* and *expected residual returns*. Those components are:

(a) The expected variability in the entity's net income or loss
(b) The expected variability in the fair value of the entity's assets (except as explained in paragraph 12) if it is not included in net income or loss
(c) Fees to the decision maker (if there is a decision maker)
(d) Fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

For purposes of this FSP, components (c) and (d) are referred to as *paragraph 8 fees*. Note that components (a) and (b) are *variability* in net income or loss and changes in asset fair value; whereas components (c) and (d) are the fair value amounts of the fees. Fees described in paragraph 8 will always be variable interests in the entity, unless the fees are excluded from paragraph 8(c) by other guidance. According to paragraph 6 of Interpretation 46, "… interests that will absorb portions of a variable interest entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur are called variable interests." Even if a paragraph 8 fee is a fixed amount and will absorb no losses in any of the estimated outcomes used to determine expected losses of the entity, the fee is a variable interest because it will receive a portion of the expected residual returns of the entity if they occur.

A—Calculation of Expected Losses

For the purpose of calculating an entity's expected losses and expected residual returns, the expected variability in the entity's net income or loss is determined based on the various estimates of net income or loss *available to, or absorbed by, the variable interest holders*. Therefore, paragraph 8 fees that are reported as an expense in determining the net income or loss of a variable interest entity, should be added back to the estimates of net income or loss used in developing the estimates of net income or loss available to, or absorbed by, the variable interest holders.

Paragraph 14 of Interpretation 46 provides the guidance for determining whether a variable interest entity has a primary beneficiary and who that primary beneficiary is. If a variable interest or combination of interests of an entity (with consideration of interests held by its related parties and de facto agents) will absorb a majority of the expected losses if they occur, that enterprise is the primary beneficiary and it is not necessary to compute expected residual returns. That is true even if expected residual returns will be larger than expected losses. If a primary beneficiary is not identified based on the analysis of expected losses, it will be necessary to analyze expected residual returns.

Calculation of Expected Residual Returns

If a variable interest entity does not pay paragraph 8 fees, the entity's *expected residual returns* is equal to the absolute value of its *expected losses* (as demonstrated by the example in Appendix A of Interpretation 46). If the variable interest entity pays paragraph 8 fees, the *expected residual returns* is equal to the absolute value of the expected losses plus the fair value (as opposed to the variability) of the paragraph 8 fees. The fair value[1] of each paragraph 8 fee should be based on

[1] If the example in Appendix A of Interpretation 46 provided a decision maker with a fee of five percent of cash flows to be paid at the end of the year, the paragraph 8 fee would be $37,857 ($795,000 × 5% = $39,750, discounted for 1 year at 5 percent).

information that is consistent with the assumptions, such as cash flows and discount rates, used to determine the variable interest entity's expected losses.

The Basis for Conclusions section of Interpretation 46 states:

> The ability to make decisions is not a variable interest, but if the decisions significantly affect the value of the variable interests, decision making will almost certainly be directly or indirectly associated with the holder of a significant variable interest. For that reason, decision making is an indicator of the primary beneficiary of a variable interest entity.

Guarantors of the values of all or substantially all of the entity's assets and guarantors of all or substantially all of the entity's liabilities are also likely to have the ability to make significant decisions for the entity. Because decision making is an indicator of the primary beneficiary, fees paid to decision makers and guarantors are added to the variability components of expected residual returns, increasing the likelihood that the decision maker or guarantor will be identified as the primary beneficiary. Expected residual returns allocated to a decision maker or guarantor receiving paragraph 8 fees would include (1) the decision maker's or guarantor's allocated share of the variability components (paragraphs 8(a) and (b)), if any, plus (2) the fair value of the decision maker's or guarantor's paragraph 8 fees.

For purposes of calculating expected losses and expected residual returns of the entity, other interests in the entity held by a decision maker or guarantor are not considered paragraph 8 fees unless those interests represent compensation for the provided service or guarantee.

The Exhibit A of FSP FIN 46-d to this FSP illustrates a calculation of expected losses and expected residual returns and the determination of the primary beneficiary when fees are paid to a decision maker.

Effective Date and Transition

The guidance in this FSP is effective for initial evaluations of arrangements and required reconsiderations of arrangements that occur after the beginning of the first fiscal quarter following the date the final FSP is posted to the FASB website. (The beginning of the first fiscal quarter after the final FSP is posted is expected to be January 1, 2004 for a calendar year entity.) Early application for initial evaluations and required reconsiderations is encouraged.

Application of the guidance in this FSP to reevaluate whether an existing entity is a variable interest entity and whether an existing variable interest holder is the primary beneficiary of a variable interest entity is encouraged. If applying the guidance in this FSP to reevaluate existing arrangements results in changes to previously reported information, the cumulative effect of the accounting change shall be reported as of the beginning of the fiscal quarter to which the reevaluation applies. For example, if a calendar-year entity reevaluates arrangements existing as of July 1, 2003, the previously issued third quarter financial statements should be restated with the cumulative effect adjustment reflected in the third quarter financial statements. If a calendar-year entity reevaluates arrangements existing as of October 1, 2003, the cumulative effect adjustment should be reflected in the fourth quarter financial statements.

The requirements of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

For enterprises that have not yet applied the provisions of Interpretation 46 to variable interests in variable interest entities in accordance with the effective date provisions of paragraph 27 of Interpretation 46, the guidance should be applied as a part of its initial adoption.

Exhibit A of FSP FIN 46-d

Calculation of Expected Losses and Expected Residual Returns When Fees Are Paid to a Decision Maker and Determination of Primary Beneficiary

The following is an illustration of a computation of expected losses and expected residual returns when an entity pays fees to a decision maker. This example is the same as the example in Appendix A of Interpretation 46, except that the first two assumptions have been modified so that no single party holds a majority of the beneficial interests in the entity and there is a decision maker.

This illustration is based on a hypothetical pool of financial assets with total contractual cash flows of $1 billion. The following assumptions have been made to simplify the illustration:

1. No single party holds a majority of the beneficial interests in the entity, and the entity has no liabilities.
2. A decision maker receives a fee of 5 percent of cash flows to be paid at the end of the year. The fees will be paid before any amounts are paid to beneficial interest holders. In addition to the right to receive its fees, the decision maker owns 10 percent of the other beneficial interests. The decision maker is not related to any other variable interest holder under the provisions of paragraph 16 of Interpretation 46.
3. All cash flows are expected to occur in one year or not to occur at all.
4. The appropriate discount rate (in this case, the interest rate on risk-free investments) is 5 percent.
5. No other factors affect the fair value of the assets. Thus, the present value of the expected cash flows from the pool of financial assets is assumed to be equal to the fair value of the assets.

Expected Losses

Table 1 shows the computation of expected cash flows of the pool using the cash flow possibilities that the variable interest holders have identified.

Table 1
(Amounts in Thousands)

Estimated Net Cash Flows	Estimated Fees	Estimated Cash Flows Available to Variable Interest Holders	Probability	Expected Cash Flows Available to Variable Interest Holders	Fair Value
$617,500	$32,500	$650,000	5.0%	$ 32,500	$ 30,952
665,000	35,000	700,000	10.0	70,000	66,667
712,500	37,500	750,000	25.0	187,500	178,571
760,000	40,000	800,000	25.0	200,000	190,477
807,500	42,500	850,000	20.0	170,000	161,905
855,000	45,000	900,000	15.0	135,000	128,571
			100.0%	$795,000	$757,143

The items to be included in expected cash flows of a variable interest entity are described in paragraphs 8(a) and (b) of Interpretation 46. Estimated cash flows used to calculate the expected losses of the entity are not reduced by the decision maker's fees. The expected cash flows available to variable interest holders of $795,000 is the probability-weighted expected outcome for this entity. The expected cash flows available to variable interest holders is the expected outcome before the payment of expected decision maker fees of $39,750 ($795,000 × 5%) or distributions to other variable interest holders.

Table 2 shows how expected losses are computed once the expected cash flows available to variable interest holders are determined.

Table 2
(Amounts in Thousands)

Estimated Cash Flows Available to Variable Interest Holders	Expected Cash Flows Available to Variable Interest Holders	Difference	Probability	Expected Losses of the Entity Based on Expected Cash Flows	Expected Losses of the Entity Based on Fair Value
$650,000	$795,000	$(145,000)	5.0%	$(7,250)	$(6,905)
700,000	795,000	(95,000)	10.0	(9,500)	(9,048)
750,000	795,000	(45,000)	25.0	(11,250)	(10,714)
800,000	795,000	5,000	25.0		
850,000	795,000	55,000	20.0		
900,000	795,000	105,000	15.0		
				$(28,000)	$(26,667)

Estimated cash flows (possible outcomes) are compared with the computed expected cash flows (probability-weighted outcomes). Estimated cash flows that are less than the expected cash flows contribute to expected losses.

Expected Residual Returns

Table 3 shows how expected residual returns are computed for the same pool of assets.

Table 3
(Amounts in Thousands)

Estimated Cash Flows Available to Variable Interest Holders	Expected Cash Flows Available to Variable Interest Holders	Difference	Probability	Expected Residual Returns Based on Expected Cash Flows	Expected Residual Returns Based on Fair Value
$650,000	$795,000	$(145,000)	5.0%		
700,000	795,000	(95,000)	10.0		
750,000	795,000	(45,000)	25.0		
800,000	795,000	5,000	25.0	$1,250	$1,191
850,000	795,000	55,000	20.0	11,000	10,476
900,000	795,000	105,000	15.0	15,750	15,000
				$28,000	26,667
		Fair value of fees from Table 4			37,857
		Expected residual returns of the entity			$64,524

Estimated cash flows that exceed the expected cash flows contribute to expected residual returns. Paragraph 8(c) of Interpretation 46 requires that expected residual returns also include fees paid to a decision maker.

Table 4 illustrates the calculation of the fair value of the fees included in the calculation of expected residual returns in Table 3. The fair value calculation is based on the same estimated cash flows and discount rates used to calculate the entity's expected losses.

Table 4
(Amounts in Thousands)

Estimated Fees	Probability	Expected Fees	Fair Value of Fees
$32,500	5.0%	$1,625	$1,548
35,000	10.0	3,500	3,333
37,500	25.0	9,375	8,928
40,000	25.0	10,000	9,524
42,500	20.0	8,500	8,095
45,000	15.0	6,750	6,429
	100.0%	$39,750	$37,857

Determination of Primary Beneficiary

This example has illustrated the application of the guidance in the FSP on the calculation of an entity's expected losses and expected residual returns when fees are paid to a decision maker. The remainder of this example illustrates how the entity's expected losses and expected residual returns would be allocated to the variable interests for purposes of determining the entity's primary beneficiary in accordance with paragraph 14 of Interpretation 46.

Allocation of Expected Losses

Table 5 illustrates how expected losses of the entity are allocated to the variable interests.

Table 5
(Amounts in Thousands)

	Expected (Probability Weighted) Outcome (Undiscounted Cash Flows)	Expected Loss Outcome (Undiscounted Cash Flows)	Difference (Undiscounted Cash Flows)	Differences (Discounted)
Amounts to be allocated to variable interests				
Expected cash flows available to variable interest holders	$795,000	$795,000		
Expected losses		(28,000)	$28,000	$26,667
Cash flows available to variable interest holders if expected losses occur		$767,000		
Allocation to variable interests				
Return to decision maker (5% fees)	$(39,750)	$(38,350)	$(1,400)	$(1,333)
Return on other variable interests	(755,250)	(728,650)	(26,600)	(25,334)
Amount received by variable interest holders	$(795,000)	$(767,000)	$(28,000)	$(26,667)

In this example, there are two types of variable interests: the decision maker's fees and the other beneficial interests. The cash flows that would be available to the variable interests under the expected (probability-weighted) outcome and the expected loss outcome are allocated to those interests based on contractual arrangements. The differences between the amounts allocated under the expected (probability-weighted) outcome and the expected loss outcome are equal to the amount of the entity's expected loss that would be absorbed by each type of variable interest. The decision maker's fees would absorb expected losses of $1,333 and the other variable interests would absorb the remaining expected losses of $25,334.

If a variable interest or combination of interests of a single enterprise (with consideration of interests held by its related parties and de facto agents) will absorb a majority of the expected losses of $26,667 if they occur, that enterprise is the primary beneficiary. The decision maker will absorb $3,866 of the entity's expected losses. That amount includes the expected losses absorbed by the fees of $1,333 plus the decision maker's 10 percent share of the expected losses absorbed by the other variable interests ($25,334 × 10% = $2,533). Since no party holds a majority of the variable interests, neither the decision maker nor any other variable interest holder will absorb a majority of the entity's expected losses of $25,334, if they occur. Therefore, it is necessary to compute expected residual returns to identify the primary beneficiary of the entity.

Allocation of Expected Residual Returns

Tables 6 and 7 illustrate how expected residual returns of the entity are allocated to the variable interests.

Table 6
(Amounts in Thousands)

	Expected (Probability-Weighted) Outcome (Undiscounted Cash Flows)	Expected Residual Returns Outcome (Undiscounted Cash Flows)	Difference (Undiscounted Cash Flows)	Differences (Discounted)
Amounts to be allocated to variable interests				
Expected cash flows available to variable interest holders	$795,000	$795,000		
Expected residual returns, before paragraph 8(c) fees		28,000	$28,000	$26,667
Cash flows available to variable interest holders if expected residual returns occur		$823,000		
Allocation to variable interests				
Return to decision maker (5% fees)	$(39,750)	$(41,150)	$1,400	$1,333
Return on other variable interests	(755,250)	(781,850)	26,600	25,334
Amount received by variable interest holders	$(795,000)	$(823,000)	$28,000	$26,667

Table 6 illustrates the allocation of the variability components of the entity's expected residual returns described in paragraphs 8(a) and (b) to the two types of variable interests.

Table 7 illustrates how the decision maker determines its share of the entity's expected residual returns, including the paragraph 8(c) component—the fair value of its fees. The decision maker will receive a majority of the entity's expected residual returns, if they occur, and the decision maker is the primary beneficiary.

Table 7
(Amounts in Thousands)

Expected residual returns to the decision maker under paragraphs 8(a) and (b)	
Return on fees (Table 6)	$1,333
Return on 10% variable interest (10% × $25,334 from Table 6)	2,533
Expected residual returns to decision maker under paragraph 8(c) (Tables 3 and 4)	37,857
Total expected residual returns to decision maker	$41,723
Total expected residual returns of the entity (Table 3)	$64,524
Decision maker's percentage of the entity's expected residual returns	65%